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Are Growth Stocks Headed South? Don't Count on It.

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CALLS FOR THE IMPENDING COLLAPSE OF GROWTH EQUITIES, PARTICULARLY TECH STOCKS, ARE GETTING LOUDER AS THE MARKET MARCHES HIGHER AND THE SHARE OF THE BIGGEST TECH PLAYERS GROWS LARGER. **Recent investor concerns have focused on frenzied retail trading, high trading volume generally, and the dramatic rise in valuations since late March.**

I agree that valuations among the tech leaders are at expensive levels relative to their history. I also concede that the growth segment of the market has taken on some speculative characteristics as of late. However, what to *do* about it is another matter entirely. Go into cash at 0%? Rotate into bonds yielding 60 basis points?[1] Move into more defensive equity sectors? Shift from growth- to value-style investing?

My answer is to not wholesale exit the market, but rather to reassess equity exposures and seek to balance portfolio risk in light of current conditions. This may mean, among other things, reducing your growth-stock exposure somewhat and selectively increasing your stake in value stocks. In today's environment, I believe there are many strong value-oriented companies that may be attractively priced because they have been unfairly punished along with weaker cyclical companies.

That being said, overall, I continue to favor growth stocks over value stocks for the medium to longer term. Why? In my view, growth-driven companies should continue to garner a premium in a low-growth, low-yield world post COVID-19.

Tech Still Has Legs ...

FIGURE 1 highlights that tech-stock valuations, while indeed lofty by historical standards, may not be quite as rich as they appear. Price/earnings (P/E) ratios[2] have lagged the appreciation in the tech index because earnings have been so strong. In short, the technology sector has thrived in the era of COVID-19, and I believe it's likely to continue to post strong earnings going forward due to ongoing structural demand for data, storage, cloud computing, e-commerce, and artificial intelligence.

... but Is Not Without Risks

But investors should be cognizant of the risks associated with the sector. For example, regulation continues to loom over the high-profile mega-cap names and will likely remain a source of headlines. Higher interest rates, while not likely anytime soon, could also trigger a correction (as falling rates have been a driver of elevated tech-stock valuations). Even without these headwinds, the tech sector could still experience a near-term correction following its unprecedented rise this year.

Investment Takeaways

I would suggest three actions for investors to consider taking now:

1) ***Stay long tech, but less long:*** In terms of risk management, trim tech exposure but remain overweight the sector.
2) ***Balance your equity "style" risk:*** Consider rotating some of your growth

Key Points

- Amid current market conditions, investors may want to reassess equity exposures and seek to balance portfolio risk.
- Nanette continues to favor growth stocks over value stocks, especially for the medium to longer term because growth-driven companies will continue to garner a premium in a low-growth, low-yield world post COVID-19.
- Nanette expects that "safe" assets such as government bonds and higher-quality credit may fare well, while value-oriented equities may struggle more than their growth-oriented counterparts.

[1] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices, and the yield of a fixed-income security.

[2] Price/Earnings is the ratio of a stock's price to its earnings per share.

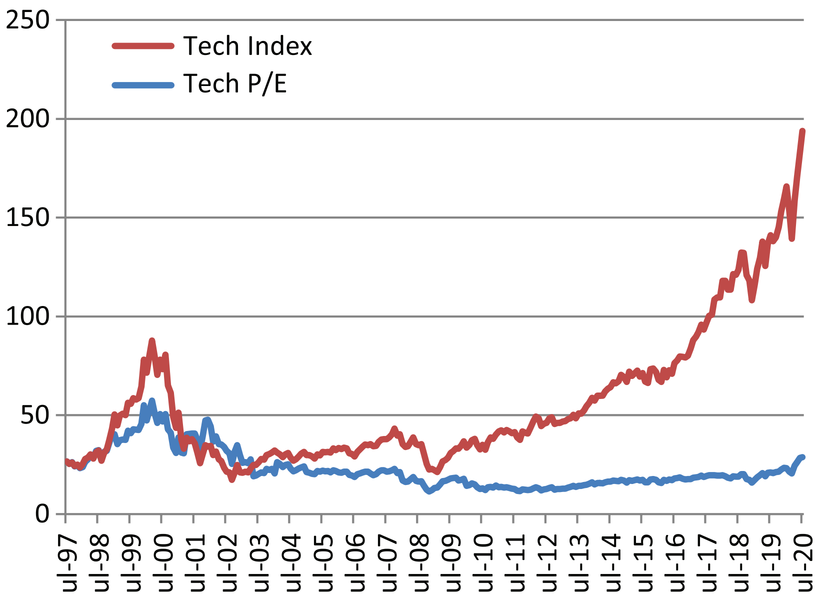
exposure to value to better balance portfolio risk.

3) ***Seek out industrial leaders:*** Look for reasonably valued industrial companies with resilient top-line growth, strong margins and free cash flow, and the power to take market share from rivals.

What's the main risk for equity investors? If the economy's nascent recovery falters amid a global resurgence of COVID-19, a deeper, longer recession could ensue, potentially taking equities down with the broader economy. In that case, I would expect "safe" assets such as government bonds and higher-quality credit to fare well, while value-oriented equities would likely struggle more than their growth-oriented counterparts.

FIGURE 1

Just How Rich Is Tech? Not As Rich As You May Think.



Source: Bloomberg. Chart data as of 7/30/20. "Tech index" shown is the S&P Information Technology Sector Index. "Tech P/E" is the tech index's price/earnings ratio, calculated as the last market price divided by trailing 12-month earnings per share of the companies in the index. Earnings per share is the projected growth rate in earnings per share for the next five years. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment.

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